Unhappy New Year

UBS House View - CIO Reaction

It took only two trading days into 2019 for equity markets to resume the selling and volatility they experienced to end 2018. On the second trading session of the year, the S&P 500 fell by 2.5%, led by a 5.1% decline in the tech sector. US Treasury yields also continued their decline, with the 10-year yield down to 2.56%, the lowest level in almost a year.

**Why did this happen?**

Equities sold off in response to a flurry of negative headlines that have greeted investors returning from the holiday season. It started on Wednesday with Chinese PMI manufacturing data in contraction territory for the first time in 19 months. It continued on Thursday, first with US tech giant Apple cutting its earnings outlook for the fourth quarter of 2018 by about 10%, rekindling fears of peak smartphone demand. Then the closely watched US ISM Manufacturing index came in at 54.1 in December, below consensus estimates of 57.5, and down from 59.3 in November. Even more dramatic was the fall in the new orders component: 51.1 vs. 62.1 in November. The decline in the ISM, especially the new orders component, was likely distorted by companies front-running an expected increase in the US tariffs on China that were originally scheduled for 1 January.

These data points have heightened investors’ concerns about slowing US and global growth. In addition, the partial US federal government shutdown and political rancor in Washington have exacerbated the uncertainty.

**What’s our view?**

Equity market valuations have clearly fallen in the sell-off. The S&P 500, for instance, entered 2018 at 18.5x forward earnings; it is now trading at 14x, below the long-term average of 15.2x. Global equities are trading around 13x forward earnings, versus a long-term average of 15.7x. But greater short-term support for markets will likely materialize only once we see greater clarity about trade disputes, and we see leading economic indicators begin to stabilize or increase. While these uncertainties persist, investors should expect volatility to continue.

The decline in valuations suggests that this could prove in time to be a good long-term entry point. That said, with significant uncertainty about the short-term path for some key market drivers, investors should prepare for continued volatility. In our tactical asset allocation, we combine overweight positions in global equities and emerging market sovereign debt, with countercyclical positions, like exposure to Japanese yen, and a put spread.

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Appendix

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